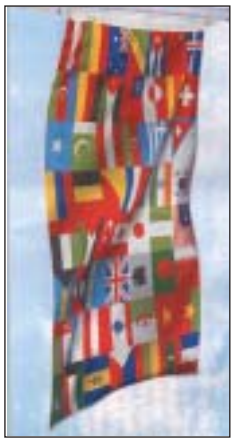
International hiring of personnel — OECD's New Thinking



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In the wake of globalization and the increased presence of multinational organizations in various countries, global mobility of labour is the need of the hour to meet the requirements of specialized skills and expertise of various entities across the globe.

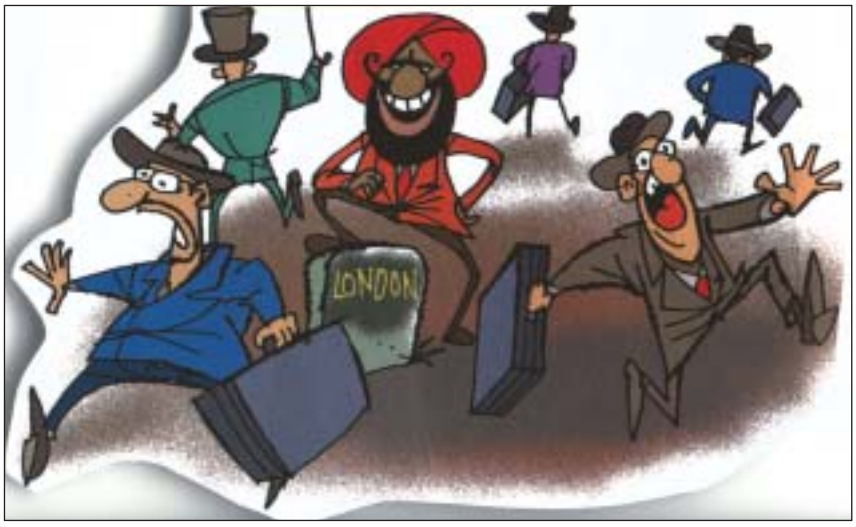
Companies located in India employ personnel from other countries to render services in India or to their affiliates in a third country. Such personnel continue to be in employment of the entity located in the country of residence and render services across the globe. They may be deputed for a short or long period of time to render limited or full-fledged services to the entities.

Taxation of such personnel is a matter of large debate and hence assumes tremendous importance for discussion. The state of residence of such personnel would seek to tax them on their worldwide income whereas the country of source would seek to tax the said individual on the sourcing principle. This could cause undue hardship to employees, as it would result in dual taxation of the employees in two countries.

Various double tax avoidance treaties entered into by countries seek to address this issue by making provisions in their treaties to avoid such dual taxation. Employment income earned by the personnel has been taxed in Article 15 as "Dependent Personnel Services" in most of the international tax treaties.

The interpretation of the applicability and various terms used in the said Article has given rise to many issues. Amongst others, the following issues assume tremendous importance in light of the issues being faced by most of the transnational companies who have international secondments:

- questions regarding the interpretation of the word "employer" ; and
- the methodology of computation of the 183 days period of stay of the personnel.



Existing OECD commentary

The present OECD Commentary on the above mentioned text of Article 15 (Taxation of Income from employment) recognises that paragraph 2

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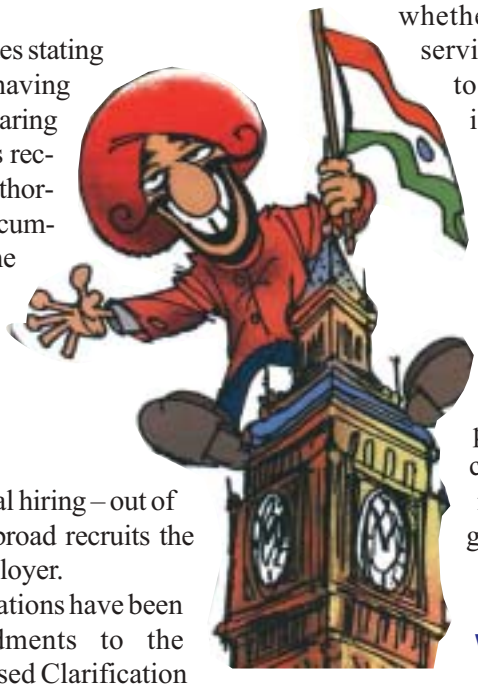
providing the 3 conditions for claiming exemption of salary income in the state where employment is exercised has wide scope for abuse. To prevent such abuse, it suggests that the term "employer" should be interpreted in the context of paragraph 2, as the same has not been specifically defined in the Convention. In all such cases the substance over form would need to be seen to determine the real employer.

The OECD commentary, besides stating that the employer is the person having rights on the work produced and bearing the relative responsibility and risks recommends that the Competent Authorities should refer to a number of circumstances viz. which entity instructs the worker, who provides tools to the worker, place where the work is performed etc. to establish the real employer.



The above Commentary has been given in the context of a practice known as "international hiring – out of labor" wherein an intermediary abroad recruits the workers and purports to be the employer.

To a great extent the abuse situations have been addressed by way of amendments to the Conventions and also in the Proposed Clarification of the Scope of Paragraph 2 of Article 15 of the Model Tax Convention.

Proposed Commentary

The Proposed Commentary has focussed on the interpretation of the terms "employer" and "employment". It records the OECD's views on where is the real employer/employment.

It envisages a situation where an assignee, being on the rolls of the non-resident enterprise, has claimed short –stay exemption even though they are actually rendering services in the position of an employee to a resident enterprise. The Commentary seeks to establish that in substance by way of application of an indicative list of tests, the employee is not entitled to a short–stay exemption, as he would be a defacto employee of the resident enterprise. It seeks to curb the practice of seconding employees in a way so as to reduce employee costs by factoring a short-stay exemption.

The proposed revised Paragraph 8 of the Commentary on Article 15, which deals with so-called "hiring-out of labor", makes interesting reading and addresses one aspect of the above issue. Earlier the Commentary was silent on the interpretation of the term "employer" found in sub-paragraphs 2 (b) and (c) of Article 15 of the Model Tax Convention, in particular as regards the domestic law definition of that term.

It emphasizes the need to ascertain whether such deputed personnel render services under the directions of the entity to which they are deputed or the deputing company provides services through such personnel.

In the Proposed Commentary it has been suggested that the application of paragraph 2 should be discussed in the context of the distinction between employment and self-employment, which is a common issue that tax authorities and taxpayers most confront. Further practical examples have been provided to illustrate the application of the paragraph in various common situations.

Rendering of services vis-à-vis provision of services

The revised paragraph 8 purporting to replace the existing paragraph 8 of the OECD Model Commentary seeks to distinguish between services rendered by an individual to an enterprise (to be taxed under Dependent Personnel Services) vis-a-vis a contract for the provision of services (to be taxed as "Managerial, Technical or Consultancy services under Article 12 or Business profits under Article 7). For this purpose, various illustrations have been discussed which give a deeper insight into the issue under consideration.

Accordingly, a distinction would need to be made between personnel deputed by a foreign entity to an entity in another jurisdiction who would work under the supervision of the other entity and the rendering of services by the foreign entity through its deputed personnel.

Article 7 and 12, generally cover situations where the recipient of fees is itself responsible for the provision of services. In most of the cases, the foreign entities are merely obliged to depute personnel to render services to the other entities as per the requirements and specification of the other entities. The foreign entity per se does not render any services in the other jurisdiction.

The deployment of services of the personnel is the primary responsibility of the Indian entity only.

However, there may be a disagreement between States on the issue of whether services rendered by an individual may be regarded as an employment relationship rather than as a contract for services between two enterprises. Any disagreement between the States may be resolved having regard to the following principles and examples as illustrated in the Proposed Commentary.

Listed below are a number of circumstances (referred to in the Proposed Commentary) which will enable the determination of whether there persists an employment relationship different from a formal contractual relationship and if so, who is the "employer" in the contract of employment:

- Which entity bears the responsibility or risk for the results produced by the individuals work;
- Which entity has the authority to instruct the individual;
- Which entity controls and has responsibility for the place at which the work is performed;
- Which entity bears, in an economic sense, the cost of the remuneration paid to the individual;
- Which entity provides the tools and materials required to perform the work at the individual's disposal; and
- Which entity determines the number and qualification of the individuals performing work.

On an application of the above conditions, one would have to determine who is the "real employer". The tests to determine the real employer are generally applied only to prevent treaty abuse.

It would be interesting to understand the concept of "real employer" versus "legal employer" with the aid of the following example:

Company X, US deputes an employee to render services to Company Y in India. The payroll of the deputed employee would remain with Company X whereas Company Y would provide all other amenities and benefits.

The taxability of the said deputed employee would need to be examined under the provisions of the Income-tax Act, 1961 and the Indo-US tax treaty. Under the provisions of the Act, the employee would be taxed based on his residential status and the sourcing principle.

As per the Indo-US DTAA, the employee would be taxed in the country where his employment would be exercised i.e. India, subject to a short stay exemption as provided in Paragraph 2 of the Article 16 (Dependent Personnel Services) of the DTAA.

Accordingly, such employees will be taxable only in the US if the following conditions are cumulatively satisfied:

- They are present in India for not more than 183 days and
- Their remuneration is paid by or on behalf of an employer who is not resident in India and
- The remuneration is not borne by a permanent establishment in India.

While the condition pertaining to period of stay is factual and would have to be determined based on the number of days of stay, it would be necessary to ascertain whether Company X or Company Y is the employer and who bears the cost of remuneration of such employees.

Identification of the Employer

(a) **Company X as the employer:** The payroll of the deputed employee would continue to be with Company X in the US. It could be established that Company X is the employer based on the fact that Company X is paying the actual salaries and other social security benefits to the employee. Hence, Company X may be regarded as the legal employer. In this scenario (Company X being considered as the employer), Company X would expose a PE in India in a situation where the treaty provides for a Service PE due to the presence of employees of a Contracting State in the other State where the services are rendered for a stipulated period.

(b) **Company Y as the employer:** As elaborated above, the term "employer" is understood to be the person having the rights on the work produced by the employee and bearing the relative responsibility and risks of the work of the employee. The term employer would include a person under whose authority (control) the employee performs his duties. In the given case, applying the tests enumerated above, it could be said that the deputed employees work under the control and supervision of Company Y, i.e. the "real employer"

Moreover, Company Y would undertake the primary risk and any benefits flowing out of the employment. Thus, as Company Y performs all the functions of an employer, for all legal and regulatory purposes, Company Y may be considered as the "real employer" even though Company X is the legal employer.

Should it be envisaged that Company X would crosscharge Company Y, the actual cost incurred on deputation of the said personnel, the issue of withhold-

ing tax implications would arise.

Rightfully, tax would have to be withheld under the provisions of Section 192 of the Income-tax Act vis-à-vis Section 195 of the Act, as Section 195 has a specific exclusion for income assessable under the head Salaries.

Quite interestingly, we already have a judicial precedent to support this proposition in the case of HCL Infosystems rendered by the Delhi Tribunal. In this case, the technicians were placed at the disposal of the Indian company and the assessee without any profit element reimbursed the salary costs. The contract had all the elements to conclude that defacto they were employees of the Indian entity i.e., the master servant relationship was present and only for the purpose of certain retiral benefits their payroll was maintained abroad. The agreement was held to be one merely for the reimbursement of payroll cost incurred in respect of the deputed technicians.

The Tribunal held that on such reimbursements, the provisions of Section 195 would not apply as tax has already been paid as per Section 192.

A point, which the author would like to mention, is that the concept of legal and real employer may not be of much relevance when the contract is with two independent companies. However, if it is a situation where it is a contract structured between related companies the point becomes relevant and the issue of whether Article 15 has application needs greater analysis.

(c) Dual employers – Company X and Company Y as employers

Considering the fact that both Company X and Company Y are compensating the deputed employees, it could be contended that Company Y is not the sole-employer even though the risks and rewards of employment accrue to Company Y. Moreover, generally the deputed expatriate would return to Company X on the completion of their period of deputation. In view of the above, it can be concluded that neither Company X nor Company Y are the sole-employers of the deputed employee.

It could be established that the deputed expatriate is in dual employment with Company X as well as Company Y.

The Proposed Commentary did not envisage and address the problem of "Dual employment" discussed above. Hence, one would need to apply the relevant tests as discussed above and determine the "real employer" for all practical purposes.

In light of the above, where mobility of labour is the ongoing trend, the interpretation of the applicability of Article 15 has assumed great importance. The concept of residency as per the domestic laws of the state and dual employment may lead to double taxation of the deputed personnel. Further, contradictory legislative and jurisprudential rules and criteria (substance over form rule etc.) and judicial precedents also raise pertinent issues as regards the taxability of the deputed personnel.

In such a scenario, it would be imperative for the personnel to ascertain clearly their tax positions in the country of employment and country of residence on deputation prior to their deputation.

Conclusion

As far as India is concerned the applicability of Article 7 on a contract for rendering of services given in the Commentary does not impact it in anyway as India has borrowed the 'Service PE' concept from the UN Model Convention and incorporated it in Article 5 dealing with PE situations.

However, the position is not the same when Indian companies depute personnel abroad to render services under a 'contract for services' or provision of services under a "contract of employment". This scenario being more prevalent in the software industry where onsite services are an imperative part of all contracts. In such a situation, the Proposed Commentary gives rise to interesting implications, as most of the countries where Indian employees are deputed to render onsite services are OECD member countries which do not manifest the concept of "Service PE" in their Tax Treaties.

So if an Indian entity constantly deputes employees onsite under a contract for the provision of services, it may give rise to tax implications under the provisions of Article 7 (Business Profits) of the Treaty.

The Revenue Authorities while dealing with the issue of short-stay exemption may go into the concept of "real employer" and hence Indian entities deputing personnel abroad, hitherto claiming short stay exemptions on deputation abroad, may be faced with the following repercussions:

- Denial of short – stay exemption to its deputed employees in a "contract of employment" ;
- Exposure under the Provisions of Article 7 (Business Profits) of the treaty which may trigger of PE and other allied issues in a "contract for the provision of services".

To sum up, the changes proposed can increase the cost of international secondments of personnel at the same time also trigger off an exposure to "Service PE" which was hitherto quite alien under the OECD Model Commentary. ■